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No. 124

In the Supreme Court of the United States

OCTOBER TERM, 1930

THE FIRST NATIONAL BANK OF CHICAGO, A NATIONAL BANKING ASSOCIATION, PETITIONER

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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OPINION BELOW

The opinion of the Court of Claims (R. 17–31) is reported in 69 C. Cls. 312, and in 38 F. (2d) 925.

JURISDICTION

The judgment of the Court of Claims was entered on March 3, 1930. (R. 31.) The petition for certiorari was filed on May 16, 1930 (R. 32), and the writ was granted June 2, 1930 (R. 33), 281 U. S. 719. The jurisdiction of this Court is invoked under Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

When a joint-stock land bank is affiliated with a corporation engaged in a general banking business and a consolidated income-tax return is filed for both, does Section 234 (a) (2) of the Revenue Act of 1921 permit a deduction from the gross income of the affiliated group, of interest paid or accrued during the taxable year on farm-loan bonds issued by the joint-stock land bank to acquire funds to loan on farmers' first mortgages?

STATUTES INVOLVED

The statutes involved are set forth in Appendix A, *infra* pp. 28–30.

STATEMENT

The petitioner is a national banking association, having its principal place of business at Chicago, Illinois. (R. 13.) On or about March 14, 1923, the petitioner filed a tentative consolidated income and profits-tax return for the year 1922 for itself and five affiliated corporations, including two joint-stock land banks. On or about June 13, 1923, the petitioner filed a completed return for the affiliated group, showing a net income of $3,482,004.88. (R. 13.)

In computing the net income of the group, the petitioner deducted the amount of $78,807.80 as being interest paid during the year 1922 on farm-loan bonds of the two joint-stock land banks with which it was affiliated. The Commissioner of Internal Revenue disallowed all of this deduction except $5,810.25, representing certain intercom-

pany transactions, which petitioner concedes is not deductible provided the balance is determined to be deductible. (R. 13, 14.)

On or about November 25, 1927, the petitioner filed a claim for refund in the amount of $9,124.70 based upon the disallowance of the deduction for interest paid or accrued on farm-loan bonds. This claim was rejected by the Commissioner on February 14, 1928. (R. 14, 15.)

The two joint-stock land banks with which the petitioner is affiliated were organized under the Federal Farm Loan Act of July 17, 1916, c. 245, 39 Stat. 360. The interest paid or accrued on their farm-loan bonds for the year 1922, which is claimed as a deduction, amounted to $72,997.55. (R. 14, 15.)

The proceeds of the farm-loan bonds were used to make additional loans to farmers on the security of first mortgage notes in accordance with the provisions of the Federal Farm Loan Act. (R. 15, 16.) The interest received by the joint-stock land banks on such notes was not taxed as income to the petitioner for the year 1922.

SUMMARY OF ARGUMENT

The language of Section 234 (a) (2) of the Revenue Act of 1921 is clear and unambiguous and should therefore be interpreted without reference to legislative history or other extrinsic facts designed to qualify the intent expressed in the statute. Under the express provisions of the section a taxpayer may not deduct from gross income interest on "indebtedness incurred or continued to purchase or carry obligations or securities * * * the

interest upon which is wholly exempt from taxation under" the Income Tax title.

The indebtedness represented by farm-loan bonds issued by joint-stock land banks is incurred or continued for the purpose of purchasing or carrying farmers' first-mortgage notes. The interest on such notes is exempt from income tax and is therefore "exempt from taxation under" the Income Tax title, regardless of the source from which the exemption is derived. Moreover, it is specifically exempted by Section 213 (b) (4) (b) as "interest upon * * * securities issued under the provisions of the Federal Farm Loan Act."

If the deduction of interest paid on farm-loan bonds be denied to joint-stock land banks, no legislative policy is violated. The purpose of the interest deduction exception clause is to prevent taxpayers from deriving a double benefit from holding tax-exempt securities. Because Congress has extended certain favors to joint-stock land banks, it does not follow that the Revenue Act must be so construed as to grant them a further immunity.

Since the taxable income of a joint-stock land bank is relatively small, denial of this deduction does not constitute a substantial burden. Moreover, where, as here, the land bank is affiliated with a general banking corporation the burden is almost exclusively on the affiliated corporation rather than on the land bank, so that the benefit to the land bank, if the deduction were permitted, would be negligible.

ARGUMENT

I

PRELIMINARY STATEMENT

Joint-stock land banks are authorized by Section 16 of the Federal Farm Loan Act of July 17, 1916, c. 245, 39 Stat. 360, 374 (U. S. C., Title 12, Sec. 811–821), to issue farm-loan bonds for the purpose of acquiring funds which may be loaned to farmers on the security of first-mortgage notes. The interest paid by the farmers on their mortgage notes is exempt from taxation as income to the joint-stock land banks. We submit that such banks are not entitled to a further deduction from their gross income on account of the interest paid by them on their farm-loan bonds. Such bonds are within the scope of Section 234 (a) (2) of the Revenue Act of 1921 (*infra*, pp. 28–29), denying deduction of interest on—

> indebtedness incurred or continued to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation under this title.

The petitioner contends that farm-loan bonds are not within the spirit or the express terms of the above clause, and endeavors to show that the language of the clause must be construed in the light of certain general legislative policies. The Government, on the other hand, takes the position that the meaning of the clause is clear and unambiguous, that its effect should not be limited by considera-

tions of supposed legislative intent, and that denial of the deduction in question would not be violative of any policies which Congress has established.

The burden of establishing an exemption from taxation is on the taxpayer. *Botany Worsted Mills* v. *United States*, 278 U. S. 282, 289, 290; *Franciscus Realty Co.* v. *Commissioner*, 39 F. (2d) 583 (C. C. A. 8th). Here the taxpayer is attempting to show that a statute expressly refusing exemption of interest paid on money borrowed to purchase or carry tax-exempt securities should be so construed as not to include this taxpayer while including others similarly situated. We submit that the petitioner has not succeeded in establishing its right to the deduction claimed, and the greater part of this brief will necessarily be devoted to a consideration of the arguments advanced by the taxpayer for the purpose of defeating the plain meaning of the statute.

II

THE INDEBTEDNESS REPRESENTED BY THE FARM-LOAN BONDS ISSUED BY PETITIONER'S SUBSIDIARY JOINT-STOCK LAND BANKS WAS INCURRED OR CONTINUED "TO PURCHASE OR CARRY" FARMERS' FIRST-MORTGAGE NOTES

In its analysis of the language of Section 234 (a) (2) of the Revenue Act of 1921 (*infra*, pp. 28–29), the petitioner first contends that the indebtedness of a joint-stock land bank represented by bonds which are issued to create a fund for making loans to

farmers on the security of first-mortgage notes is not "indebtedness incurred or continued to purchase or carry" such mortgage notes.

While conceding, for the sake of argument, that in order to come within the interest deduction exception clause, the indebtedness must be incurred or continued for the express purpose of purchasing or carrying exempt securities, we submit that such purpose is clearly indicated in the instant case. The Court of Claims found that the proceeds of the farm loan bonds issued by the petitioner's subsidiaries were used to make loans to farmers "which new loans * * * were made in each instance in consideration of the making and delivery by the borrowing farmers, respectively, of their promissory notes secured as to payment by first mortgages on their farms." (R. 15, Finding 6.) The court concluded in its opinion (R. 22) that the acquisition of such notes with these funds was a purchase of securities within the meaning of the Revenue Act.

In contending that this conclusion was erroneous, the petitioner disregards the dual nature of the transaction and construes various isolated phrases in the Farm Loan Act as establishing finally and for all purposes the character of the dealings between the farmer and the bank. But the relationship must be viewed comprehensively. While undoubtedly a loan is made to the farmer, that is but one phase of the transaction. Joint-stock land

banks are supported by private capital and are intended to operate at a profit. From the bank's viewpoint, therefore, its indebtedness is incurred for the purpose of enabling it to acquire interest-bearing obligations secured by first mortgages on approved farm lands. The bank hopes in this manner to secure for its stockholders a return on their investment, without which it would not be able to function. The acquisition of such obligations would seem to be a purchase within the meaning of the Revenue Act.

The provisions of the Federal Farm Loan Act were designed merely to establish and regulate the procedure whereby farmers might secure long-term loans at reasonable rates of interest. They do not purport to stamp the transaction as a loan for all purposes nor to declare arbitrarily that it may not under any circumstances be regarded as a purchase of securities.

We submit that the word "purchase" as used in the Revenue Act has no special or technical significance but should be interpreted as meaning just what it is normally understood to mean, without regard to the language of other statutes having no relation to the general field of taxation. Generally "purchase" connotes the idea of acquisition for a valuable consideration, usually monetary. As applied to the instant case this definition is clearly sufficient to bring the acquisition of first-mortgage notes by joint-stock land banks within the scope of the interest deduction exception clause.

Moreover, if the meaning of "purchase" be restricted, as petitioner urges, to the acquisition of securities which are already outstanding, and be held not to include acquisition at the time of inception, the result is to read into Section 234 (a) (2) an implied exception with respect to all tax-exempt obligations or securities as to which the taxpayer is the original obligee. We submit that such an interpretation of the Act would be entirely unjustified. The specific exclusion from the exception clause of Section 234 (a) (2) of certain Federal securities originally subscribed for by the taxpayer indicates that Congress considered that such original subscription would be a purchase and that interest on indebtedness incurred for the purpose of acquiring such securities at the time of their inception would be taxable were it not for the proviso.

While we believe that the indebtedness represented by the bonds of the joint-stock land bank is incurred for the purpose of purchasing tax-exempt securities within the meaning of Section 234 (a) (2), we submit that such indebtedness may also be incurred in some cases to carry such securities. Although the word "carry" is normally used to describe the operation of purchasing on credit where interest is paid to the vendor, it may also have a broader significance such as was assigned to it by the Court of Claims. (R. 22.) Clearly the joint-stock land bank does not pay interest on farmers' notes, but it does incur certain overhead ex-

penses in connection with its operations, and to that extent its indebtedness may be said to be incurred for the purpose of carrying these notes. See General Counsel's Memorandum 2000, VI–2 Cumulative Bulletin, p. 248.

III

FARMERS' FIRST MORTGAGE NOTES ARE "OBLIGATIONS OR SECURITIES * * * INTEREST UPON WHICH IS WHOLLY EXEMPT FROM TAXATION UNDER THIS TITLE"

The petitioner contends that the exception set forth in Section 234 (a) (2) of the Revenue Act of 1921 as to "indebtedness incurred or continued to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation under this title" must be construed to refer only to obligations or securities which are specifically exempted by Section 213 (b) (*infra*, p. 28) and that when so construed it does not include farm loan bonds for the reason that the first-mortgage notes taken as security for loans made out of the proceeds of such bonds are not "securities issued under the provisions of the Federal Farm Loan Act."

We contend that the language of Section 234 (a) (2) refers to obligations or securities the interest on which is immune from income taxation regardless of the source from which the immunity is derived. We contend further that if the petitioner is correct in stating that the exception includes only such obligations or securities as are specifically

exempted by Section 213 (b), nevertheless farmers' first-mortgage notes are "securities issued under the provisions of the Federal Farm Loan Act" and are therefore within the scope of both the exemption provisions and the interest-deduction exception clause.

A. *The exception clause of Section 234 (a) (2) refers to obligations or securities the interest upon which is exempt from income tax, regardless of the source from which such exemption is derived.*

We submit that there is no justification or necessity for looking beyond the language of the Revenue Act in order to determine the meaning of the interest-deduction exception clause. That clause prohibits the deduction of interest on all indebtedness incurred or continued in connection with the acquisition of obligations or securities "the interest upon which is wholly exempt from taxation under this title." It is obvious that the title referred to is Title II, which includes all provisions relating to income tax.

The petitioner insists that the exception should be read as though the words "from taxation" had been omitted. This is in direct conflict with the settled principle of statutory interpretation requiring that all words used by the legislature are to be given effect and meaning. *United States* v. *Standard Brewery, Inc.*, 251 U. S. 210, 218. Article 180 of Regulations 33, promulgated under the Revenue

Act of 1916, as amended by the Revenue Act of 1917, adopts the interpretation which we believe to be correct. It states that interest paid on indebtedness may be deducted from gross income—

> provided it does not include interest on indebtedness incurred in the purchase of securities, the income from which is not subject to income tax.

Grammatically, the words "under this title" should be read as a limitation upon the word "taxation," the last antecedent, rather than upon "exempt," a more remote antecedent, unless some good reason to the contrary is shown. 2 *Lewis' Sutherland, Statutory Construction* (2d ed.), p. 811. When so read the clause is entirely free from ambiguity and must be given effect according to its express terms. Its natural, obvious meaning should not be altered by judicial construction based upon a supposed general intent of the Legislature. *Bate Refrigerating Company* v. *Sulzberger*, 157 U. S. 1; *United States* v. *Lexington Mill Company*, 232 U. S. 399.

Precisely the same expression appears in Section 213 (b) in a context which renders even more unlikely the meaning which the petitioner suggests. That section provides in part as follows:

> That for the purpose of this title * * * the term "gross income" * * * (b) does not include the following items, which shall be exempt from taxation under this title * * *.

As in Section 234, the title referred to is "Title II—Income Tax." It would not be reasonable to construe the phrase "under this title" in Section 213 as limiting the word "exempt" rather than the word "taxation" inasmuch as "taxation under this title" is the burden from which the items listed in the section are exempted. It seems clear that "taxation under this title" is the equivalent of "income tax" and that the meaning of Section 213 (b) would have been exactly the same if Congress had stated that the specified items should be "exempt from income tax." Since precisely the same words are used in Section 234 (a) (2), they should receive the same interpretation.

If our interpretation of Section 234 (a) (2) is correct, interest on farm loan bonds is not deductible from gross income, since, as the petitioner concedes, farmers' first mortgage notes are exempt from the tax imposed by Title II of the Revenue Act.

B. *If the exception clause in Section 234 (a) (2) be construed as referring only to obligations or securities interest upon which is specifically exempted by Section 213 (b) (4), farmers' first-mortgage notes are still within the scope of the exception, inasmuch as they are "securities issued under the provisions of the Federal Farm Loan Act"*

In support of its contention that the interest deduction exception clause in Section 234 (a) (2)

of the Revenue Act of 1921 should be construed as referring only to obligations or securities the interest upon which is in terms exempted by Section 213 (b) (4), the petitioner relies principally upon the language of Section 26 of the Federal Farm Loan Act, c. 245, 39 Stat. 360, 380 (U. S. C., Title 12, Sec. 931–933), *infra*, pp. 29–30, in which farm-loan bonds are spoken of as being "issued under the provisions of this Act," whereas first mortgages are referred to as being "executed to Federal land banks or to joint-stock land banks." We submit that the language appearing in the Federal Farm Loan Act has no bearing on the interpretation of Section 234 (a) (2). It was intended merely to describe the instruments which should be immune from taxation, and there is no reason whatever to suppose that Congress desired to deny to first-mortgage notes the character of being "issued under the provisions of" the Farm Loan Act. The choice of language was purely fortuitous in so far as it relates to the present issue.

Further support for the petitioner's contention is sought to be derived from the history of Section 213 (b) (4) (b), which, as the petitioner has shown on pages 55 and 56 of its brief, originated in Section 4 of the Revenue Act of 1916, c. 463, 39 Stat. 756, 758. It is said that Section 4 can not have been intended to include farmers' first-mortgage notes for the reason that it applied only to exemptions to

individuals, whereas such notes are exempt only when issued or executed to corporations, i. e., Federal land banks or joint-stock land banks.

We answer that the petitioner's premise is erroneous. Section 4 of the 1916 Act appears under the income tax title, which includes all provisions relating to income tax on corporations as well as those dealing with the tax on the income of individuals. It reads in part as follows:

> The following income shall be exempt from the provisions of this title:
> * * * The obligations of the United States or its possessions or securities issued under the provisions of the Federal farm loan Act of July 17, 1916 * * *.

It will be observed that the specified items contributing to gross income are exempted by this section from the provisions of "this title," which must be construed as meaning the whole title, including that part relating to corporations. Regulations 33, issued under the Act of 1916, contain a series of articles under the heading "Income-Tax Regulations Relating to Corporations." Articles 83 to 87 under this heading deal with "Income Exempt From Tax" and show clearly that Section 4 was construed as being applicable to corporations as well as to individuals. Although the exemption in favor of securities issued under the provisions of the Farm Loan Act is not mentioned, Article 85 relates to obligations of the United States, which

are classified as exempt under the same exception. Therefore under the 1916 Act corporations were entitled to exclude, in the computation of their gross income, the exempted items specified in Section 4.

Consequently, there is no basis for the contention that Section 4 could not have been intended to include farmers' first-mortgage notes. Moreover, the premise on which the contention is founded would lead to the conclusion that interest on farm-loan bonds is not exempted by Section 4 where such bonds are held by corporations other than those protected by Section 11 (a) Fourteenth. Yet the petitioner concedes that farm-loan bonds are "securities issued under the provisions of the Federal farm loan Act" and the supposed distinction between these bonds and first-mortgage notes is not supported by the facts.

The ruling of the Income Tax Unit in I. T. 2470, VIII–1 Cumulative Bulletin, p. 69, part of which is quoted in the petitioner's brief (p. 62), does not support the contention that farmers' notes are rendered exempt solely by virtue of Section 26 of the Farm Loan Act. The ruling was made with reference to the Revenue Act of 1928, c. 852, 45 Stat. 791, 798, section 22 (b) (4) of which is substantially identical with Section 213 (b) (4) (b) of the Act of 1921. The concluding sentence of this ruling, which does not appear in the petitioner's brief, reads as follows:

> The income derived from the mortgages executed to the Federal land banks should, therefore, be excluded from gross income under the provisions of section 22 (b) (4) of the Revenue Act of 1928 and article 85 of Regulations 74.

It thus appears that the Income Tax Unit in deciding that farmers' first-mortgage notes are exempt, considered both the Revenue Act and the Farm Loan Act—the former as the primary authority for the exemption and the latter to determine what obligations or securities within the purview of the Farm Loan Act, Congress intended to relieve from the burden of taxation.

This interpretation of the ruling is supported by an earlier ruling cited on page 61 of the petitioner's brief to the effect that notes executed by joint-stock land banks are not entitled to a tax-exempt status. I. T. 1806, II-2 Cumulative Bulletin, p. 92. There is nothing to indicate that Congress intended to confer a tax-exempt status on such notes as "securities issued under the provisions of the Federal farm loan Act" since they were not exempted by the provisions of the Farm Loan Act itself. The two rulings of the Income Tax Unit merely limit the scope of Section 213 (b) (4) (b) to those instruments designated by Congress in Section 26 of the Farm Loan Act as being in the nature of instrumentalities of the Federal Government. Farmers' first-mortgage notes fall within this class.

We submit that there is no merit to the contention that first-mortgage notes are not "issued under the provisions of the Federal farm loan Act," when it is evident that they are essential to the operation of the farm loan plan, are the final security upon which the integrity of the bonds depends, and are in fact the very basis of the system created by the Act. While it is true that they do not, in the last analysis, depend for their validity on the provisions of the Farm Loan Act, nevertheless their value as integral parts of the farm loan scheme does depend entirely on their conforming to the requirements specified in the Act. Furthermore, their immunity from taxation is derived in the first place from the Farm Loan Act and is contingent upon their being in sufficient conformity with the requirements of the Act to be acceptable to land banks.

Finally, in reply to the contention that Congress contemplated that the obligations or securities referred to in Section 234 (a) (2) and Section 213 (b) (4) should include only securities of a type similar to those specified in clauses (a), (c), and (d) of Section 213 (b) (4) (obligations of the States and political subdivisions thereof or of the United States and its possessions or of the War Finance Corporation), it seems sufficient to observe (1) that the existence of such an intention is purely conjectural, and (2) that by Section 26 of the Farm Loan Act Congress expressly conferred upon farm-

ers' first-mortgage notes a degree of dignity comparable for tax purposes to that enjoyed by obligations of the Federal Government.

IV

CONSIDERATIONS OF LEGISLATIVE INTENT OR POLICY DO NOT REQUIRE THAT SECTION 234 (a) (2) OF THE REVENUE ACT OF 1921 BE INTERPRETED SO AS TO PERMIT THE DEDUCTION FROM GROSS INCOME OF JOINT-STOCK LAND BANKS OF INTEREST PAID OR ACCRUED ON THEIR FARM-LOAN BONDS

As the petitioner has pointed out in its brief, the legislative history of Section 234 (a) (2) of the Revenue Act of 1921 indicates that the exception clause was designed to discourage the practice of buying tax-exempt securities on a large scale with borrowed money and deducting interest paid on such borrowings from taxable income derived from other sources. It is clear that in issuing farm-loan bonds joint-stock land banks are merely performing one of the functions for which they were created and are not attempting to evade tax liability. The petitioner therefore concludes that the interest-deduction exception clause is not applicable to interest paid on farm-loan bonds. With this conclusion we are unable to agree.

It may be observed, in the first place, that there is no justification for petitioner's contention that the interest deduction exception clause should be limited in its application by the provisions of Section 234 (a) (1), permitting the deduction of "ordinary and necessary" business expenses. Interest pay-

ments and business expenses have always been treated as separate and distinct items with respect to deductibility. Act of October 3, 1913, c. 16, 38 Stat. 114, 172, Sec. II, G (b); Revenue Act of 1916, c. 463, 39 Stat. 756, 767, Sec. 12 (a), as amended by Revenue Act of 1917, c. 63, 40 Stat. 300, 334, Sec. 1207 (1); Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, Sec. 234 (a); Revenue Act of 1921, c. 136, 42 Stat. 227, 254, Sec. 234 (a). See also Regulations 62 (1922 ed.), Article 561. The separation of the two deductible items is as distinct here as it was in Section 38 of the Corporation Tax Act of August 5, 1909, c. 6, 36 Stat. 11, 112, construed by this Court in *Anderson* v. *Forty-two Broadway Company*, 239 U. S. 69. See *Nauts* v. *Slayton*, 36 F. (2d) 145, 146 (C. C. A. 6th), reversed on certiorari by this court February 24, 1931, *sub nom. Denman* v. *Slayton*, No. 60, October Term, 1930.

With respect to the purpose of the exception clause, there is, we submit, a real distinction between the reasons which prompted the enactment and the intent evidenced by the statute as adopted. It is frequently necessary in order that undesirable practices may be checked to legislate in terms sufficiently broad to include activities other than those at which the legislation is primarily directed. Yet if the language of the statute is clear, an unexpressed motive will not supply implied limitations where none are declared. *Caminetti* v. *United States*, 242 U. S. 470. We submit that the provi-

sions of Section 234 (a) (2) are unambiguous and that they should be taken at their face value. See *Denman* v. *Slayton, supra.*

Moreover, the purpose of the exception clause was in fact broader than the petitioner suggests. The unrestricted deductibility of interest on indebtedness gave to the exemption clause an effect substantially greater than that which it was originally intended to have, since it permitted the taxpayer to deduct from taxable income something more than the interest received on tax-exempt securities. When Congress realized that these seemingly unrelated provisions were operating together to reduce taxable income to an extent greater than had been contemplated, it inserted into Section 234 (a) (2) the exception clause now under discussion. The direct effect of the various exemption provisions remained unchanged, but their indirect effect on taxable income through the interest-deduction clause was removed.

There is no reason to believe that Congress intended the exception clause to relate only to indebtedness incurred for the express purpose of evading taxation. The petitioner itself does not contend that the taxpayer's intention is material. Nor does the statute justify a distinction being drawn between one who is engaged primarily in the purchase of exempt securities and the casual investor in such securities. See *Denman* v. *Slayton, supra.*

The situation is not analagous to that presented in *National Life Insurance Co.* v. *United States*, 277 U. S. 508. That case involved Section 245 (a) of the Revenue Act of 1921, which permitted life insurance companies to deduct from gross income interest received upon exempt securities plus a sum equal to 4% of their legal reserve diminished by the amount of such interest. This Court held there was such a direct relation between the deduction allowed for exempt securities and the diminution of the deduction for the legal reserve as to negative the constitutional exemption guaranteed to state and municipal obligations. It held further that Congress did not intend to nullify in such manner the exemption granted by statute to the obligations of the Federal Government.

But there is no direct connection between interest on exempt securities and interest on indebtedness incurred to purchase or carry such securities. The indebtedness may represent only an insignificant fraction of the exempt holdings. In the *National Life Insurance Company case* the effect of the statute was to increase the net income so that the total was the same as if the exempt income were itself taxed. In the instant case, on the other hand, the statute merely prevents the further reduction of the normal taxable basis by the payments made to buy or carry exempt securities. The income from exempt securities remains unchanged.

The instant case bears a marked similarity to *Denman* v. *Slayton, supra,* except that here, as the petitioner concedes (Br. p. 96) "there is, of course, no constitutional limitation on the power of Congress, if it so desired, to deny deduction of interest on" joint-stock land-bank bonds. Inasmuch as this Court has decided that no unconstitutional burden was imposed upon the municipal borrowing power by the tax assessed in the *Slayton case,* it follows that in the instant case there is no burden upon first-mortgage notes and no question as to the intent of Congress to avoid such a burden. Thus the principle of construction laid down in the *National Life Insurance Company case* is not relevant to the instant case. Moreover, it seems clear that an appreciable burden must be shown to exist in fact before a statute will be construed as inapplicable on that ground. See *Willcuts* v. *Bunn,* No. 22, October Term, 1930, decided January 5, 1931.

It is urged by the petitioner that inasmuch as Congress has expressly exempted from income tax the interest received on farmers' first-mortgage notes, Section 234 (a) (2) must be construed as extending the exemption to interest on indebtedness represented by farm-loan bonds. But if Congress had intended to grant a comprehensive exemption to everything connected with the operation of the farm-loan plan, it would have included joint-stock land banks among those corporations

which are entirely free from income tax. Yet, as the petitioner concedes, such banks are subject to taxation on all income received from nonexempt sources.

The income of the joint-stock land bank consists almost entirely of interest on first-mortgage notes. (Petitioner's brief, p. 84.) Such other income as it may receive is derived from the exercise of powers which are merely incidental to its main purpose. Moreover, it is admitted that in the instant case the two subsidiary land banks had no independent net taxable income in 1922, even aside from any deduction of interest paid on their bonds. (Petitioner's brief, pp. 84–85.)

If, therefore, the Revenue Act be so construed as to permit land banks to deduct from their relatively small amount of taxable income the interest paid on their land bonds, it is reasonable to believe that invariably the net result would be to leave them no taxable income whatever. If, on the other hand, the privilege of deducting interest paid on land bonds be denied in accordance, as we contend, with the plain language of the Revenue Act, the exemption of interest on first-mortgage notes would in no way be affected, and the indirect burden on the operation of the farm-loan plan would be negligible. See *Denman* v. *Slayton, supra.*

The provisions of the Federal Farm Loan Act give no indication of an intention on the part of Congress that joint-stock land banks shall receive

any favors other than those specifically set out in the Act. As the Court of Claims said in its opinion (R. 29):

> Construing the language of the exception to the interest-deduction clause in Section 234 (a) (2) to mean what the words used import deprives the plaintiff of no benefit the provisions of the Farm Loan Act accord to it. On the other hand, to give the language used the construction contended for by the plaintiff would give to it a benefit nowhere granted in the Act.

The question is of no considerable importance except in cases like the instant one where the land bank is affiliated with a corporation engaged in a general banking business and a consolidated return is filed for both. Under such circumstances the land bank probably contributes relatively little to the gross income of the group, and in the instant case it is conceded that the subsidiary land banks contributed nothing. (Petitioner's brief, pp. 84–85.) The deduction of interest on its bonds, if allowed, will affect the tax liability of the land bank slightly, if at all. Nevertheless, it is contended that a general legislative policy to relieve the farm-loan plan of certain specified burdens should be invoked as the deciding factor in interpreting the Revenue Act in such a way as to permit a deduction from the taxable income, not of the land bank but of the general banking corporation with which it is affiliated.

We realize, of course, that the consolidated return necessarily operates to the advantage of the taxpayer in some cases and to the advantage of the Government in others. If the Revenue Act clearly permitted the deduction in question, we should have no hesitation in conceding that it should be reflected in the taxable income of the affiliated group. But when the scope of the deduction clause is in dispute and the argument based on a policy of favoring land banks is adduced as a guide to interpretation, we feel free to suggest that the allowance or disallowance of the deduction will have no appreciable effect on land banks, but will react almost exclusively upon general banking corporations which are admittedly outside the protective pale.

In 1923, when the present question was first raised under the 1921 Act, the Treasury Department took the position that Section 234 (a) (2) did not permit the deduction of interest paid on farm-loan bonds (see Appendix B, *infra*, pp. 31–33). In 1927 the General Counsel of the Bureau of Internal Revenue published a memorandum on the identical question here presented and ruled that interest on farm-loan bonds was not deductible. G. C. M. 2000, VI–2 Cumulative Bulletin, p. 248. It is significant that although the practice of the Department in this respect has been uniform since 1923, the exception clause has been reenacted without change in all subsequent Revenue Acts. This would indicate that Congress was not dissatisfied with the manner in

which Section 234 (a) (2) had been construed by the Department.

CONCLUSION

The judgment of the Court of Claims should be affirmed.

Respectfully submitted.

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FEBRUARY, 1931.

APPENDIX A

STATUTES INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 238, 254, provides in part:

> SEC. 213. That for the purpose of this title (except as otherwise provided in section 233) the term "gross income"—
>
> * * * * *
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> * * * * *
>
> (4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. * * *
>
> * * * * *
>
> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *;
>
> (2) All interest paid or accrued within the taxable year on its indebtedness, except

on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

* * * * * *

The Federal Farm Loan Act of July 17, 1916, c. 245, 39 Stat., 360, 380 (U. S. C., Title 12, Secs. 931–933), provides in part:

SEC. 26. That every Federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from Federal, State, municipal, and local taxation, except taxes upon real estate held, purchased, or taken by said bank or association under the provisions of section eleven and section thirteen of this Act. First mortgages executed to Federal land banks, or to joint stock land banks, and farm loan bonds issued under the provisions of this Act, shall be deemed and held to be instrumentalities of the Government of the United States, and as such they and the income derived therefrom shall be exempt from Federal, State, municipal, and local taxation.

Nothing herein shall prevent the shares in any joint stock land bank from being included in the valuation of the personal property of the owner or holder of such shares, in assessing taxes imposed by authority of the State within which the bank is located; but such assessment and taxation shall be in manner and subject to the conditions and limitations contained in section fifty-two

hundred and nineteen of the Revised Statutes with reference to the shares of national banking associations.

Nothing herein shall be construed to exempt the real property of Federal and joint stock land banks and national farm loan associations from either State, county, or municipal taxes, to the same extent, according to its value, as other real property is taxed.

APPENDIX B

JUNE 13, 1923.

CHARLES H. PRESTON AND COMPANY,
Plymouth Building, Minneapolis, Minnesota.

SIRS: Receipt is acknowledged of your letter dated May 23, 1923, in which you make certain inquiries as to the taxable income and deductions of joint stock land banks, which information is desired in order properly to prepare the complete return for 1922 of the Southern Minnesota First Joint Stock and Land Bank, Redwood Falls, Minnesota.

You state that the chief source of the income of joint stock land banks is interest on mortgages and inquire whether such income is taxable. The statement is made that if such income is not taxable under the provisions of Section 26 of the Federal Farm Loan Act it would be an impossibility for a joint stock land bank ever to show a taxable net income and information is requested as to why it is necessary for such bank to file a return.

You refer to income tax ruling IT:1349, in which it is held that dividends on joint stock land-bank stock are subject to surtax and inquire why its dividends should be taxable if the net income received by the bank is nontaxable. You also ask whether interest paid by the bank on its farm loan bonds is allowable as a deduction.

You are advised that under the provisions of Section 26 of the Federal Farm Loan Act the interest received by joint stock land banks (organized

under that Act) on first mortgages executed to such banks is exempt from income tax. Other income received by joint stock land banks is taxable or nontaxable depending upon the character of such income.

Every corporation which is not specifically exempt from tax under the provisions of Section 231 of the Revenue Act of 1921 is required to file a return of its income. Inasmuch as joint stock land banks are not included in the corporations enumerated as exempt from taxation under that section, such banks are required to file returns although such returns may disclose no tax liability.

Dividends paid by joint stock land banks are required to be reported in gross income under the provisions of Section 213 (a) of the Revenue Act of 1921 although the chief income of such banks is interest on first mortgages which is exempt from tax. Dividends of Federal land banks and national farm loan associations are exempt from all Federal income tax under that portion of Section 26 of the Federal Farm Loan Act which reads as follows:

> Every Federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from Federal, State, municipal, and local taxation, except taxes upon real estate held, purchased, or taken by said bank or association under the provisions of section eleven and section thirteen of this Act.

There is nothing in this provision of the Federal Farm Loan Act or any other provisions of the Act

which exempts from tax the dividends paid by joint stock land banks.

The interest paid by a joint stock land bank on the farm loan bonds issued by such bank is not an allowable deduction in computing net income inasmuch as such farm loan bonds represent indebtedness incurred by the joint stock land bank to carry obligations (namely, first mortgages executed to the bank) the interest upon which is wholly exempt from income tax.

Respectfully,

E. W. CHATTERTON,
Deputy Commissioner.

By (Sgd.) H. O. ARMSTRONG,
Chief of Section.